



CITY OF MOUNTAIN VIEW

MEMORANDUM

Investment Review Committee

DATE: December 11, 2018

TO: City Council

FROM: Ken S. Rosenberg, Chair, Investment Review Committee
Patty J. Kong, Finance and Administrative Services Director

SUBJECT: Annual Report of the Investment Review Committee for Fiscal Year 2017-18

INTRODUCTION

The Investment Review Committee (Committee or IRC) convened on October 31, 2018 for its annual review of the City's investment portfolio for Fiscal Year 2017-18 and held a follow-up meeting November 26, 2018. This report contains the Committee's findings and recommendations regarding the City's portfolio and the portfolio's management program as required by [City Council Policy B-2, Investment Policy](#) (Policy) (draft with recommended changes is Exhibit A to Attachment 1 (Resolution) to the Council report). Acceptance of this report by the City Council constitutes voluntary compliance with California Government Code Section 53646(a)(2), which states that "the treasurer or chief fiscal officer of the local agency may annually render to the legislative body of that local agency and any oversight committee of that local agency a statement of investment policy, which the legislative body of the local agency shall consider at a public meeting. Any change in the policy shall also be considered by the legislative body of the local agency at a public meeting."

BACKGROUND

Section 14.3 of the Policy requires the establishment of an Investment Review Committee comprised of the members of the Council Finance Committee (CFC) and two public members with expertise in the area of fixed-income investments appointed by the City Council. The public members appointed by the City Council are Steven Permut, Vice President, Senior Portfolio Manager, and Director of Municipal Investments for American Century Investment Management, Inc. (appointed June 28, 2005), and a vacant position as Janice Phan, Corporate Treasurer for Lumentum, formerly Corporate Treasurer for LinkedIn, (appointed September 13, 2016) recently advised staff of her resignation from the Committee. The CFC is comprised of

Councilmembers John McAlister and Ken S. Rosenberg, Chair of the IRC, and Vice Mayor Lisa Matichak.

The purpose of the IRC is to provide oversight and an objective assessment of the City's investment portfolio and related matters. It is required to meet annually to review and discuss portfolio management matters with the City's external investment advisor, the City Manager, and the Finance and Administrative Services Director. All Committee and City Councilmembers receive monthly and quarterly investment portfolio status reports. A primary function of the IRC is to annually report their findings and any policy recommendations regarding the investment portfolio to the City Council. On October 31, 2018 and November 26, 2018, the IRC and other required parties met and reviewed the status of the portfolio presented by the external investment advisor and the Finance and Administrative Services Director, and considered other matters discussed in this report. This report presents the consensus findings and recommendations of the IRC from those meetings. Detailed information is included in this report summarizing the portfolio's performance and Policy compliance over the past fiscal year as well as its status at fiscal year-end.

ANALYSIS

Portfolio

Performance Requirements

The Policy requires the portfolio be managed such that it closely reflects a segment of the securities market with characteristics similar to the City's investment objectives of safety, liquidity, and yield. Evaluation of the portfolio's financial performance and Policy compliance is done by comparison to a published index referred to in the Policy as the "benchmark index." The Policy specifies the investment objective is to earn a total time-weighted rate of return over a market cycle that equals the total time-weighted rate of return of the benchmark index. The benchmark index for the portfolio is a blend of three published Merrill Lynch indices weighted as follows: 10 percent three-month Treasuries, 10 percent six-month Treasuries, and 80 percent one- to five-year Governments which is a composite of Treasury and Agency securities.

In addition to earning a market rate of return, there are several other criteria, primarily aimed at minimizing investment risk, which are used in evaluating portfolio management and compliance with the Policy. These criteria include the following:

- Investing only in securities with very high credit quality as permitted by the Policy.

- Diversity requirements that limit the percentage of the portfolio that can be invested in any one type or issuer of a security.
- Target duration requirements that limit the portfolio's risk exposure to changes in market interest rates.
- Limits on the maximum maturity of individual investments.

Evaluation of Portfolio Performance

A 10-year history of the portfolio's average duration and 12-month total rate of return (TRR) compared to the benchmark index referred to above is as follows:

Fiscal Year Ending June 30	Average Duration		TRR	
	City	Benchmark	City	Benchmark
2018	1.96	1.94	0.21	0.15
2017	2.02	2.02	-0.03	-0.12
2016	1.99	1.99	1.85	1.86
2015	2.04	2.04	1.11	1.10
2014	2.10	2.09	1.10	1.09
2013	2.05	2.11	0.07	0.05
2012	1.99	2.00	1.90	1.77
2011	1.95	1.92	1.84	1.76
2010	1.96	1.99	3.33	3.39
2009	1.92	1.97	5.39	5.47

The Policy requires that portfolio duration not exceed a maximum deviation of ± 15 percent from the benchmark duration and the portfolio must be rebalanced quarterly within ± 3 percent of the benchmark. These objectives were met throughout the fiscal year and the portfolio was managed within ± 3 percent for 10 out of the 12 months of the fiscal year. The average duration of the City's portfolio, excluding the Shoreline Bonds as approved by City Council, during this period was 1.96, slightly higher than the average benchmark duration of 1.94.

In Fiscal Year 2017-18, the City's TRR was better than the benchmark by six basis points. The annualized TRR of the portfolio compared to the benchmark since inception (August 31, 1995) is 3.65 percent and 3.60 percent, respectively. The portfolio generally tracks reasonably close to the benchmark and has outperformed Benchmark 7 of the past 10 years. The TRR is a measure of the portfolio's performance over a given period

of time. It includes interest earnings, and realized and unrealized gains and losses in the portfolio. Yield measures interest earned on the portfolio.

The City does not actively manage its investments with frequent buy and sell transactions but generally holds securities to maturity. While rising interest rates reduce the market value of portfolio securities acquired when rates were lower, market-value losses are not realized when securities are held to maturity.

Investment returns have suffered since the great recession as the Federal Reserve has held short-term interest rates at historical lows in order to support growth in the economy. During the past two fiscal years, 2016-17 and 2017-18, the Federal Reserve increased rates three times each year (December 2016 and 2017, March 2017 and 2018, and June 2017 and 2018). While rates are still low, the securities that have matured during this past fiscal year have been reinvested at higher interest rates.

A 10-year history of the average portfolio, the interest earned, and the yield is as follows (dollars in millions):

Fiscal Year Ending June 30	Average Portfolio	Interest Earned	Yield
2018	\$585.8	\$9.3	1.58%
2017	\$454.6	\$5.8	1.27%
2016	\$407.5	\$4.7	1.16%
2015	\$373.0	\$4.2	1.14%
2014	\$343.7	\$4.3	1.26%
2013	\$306.9	\$4.9	1.59%
2012	\$288.6	\$5.9	2.05%
2011	\$252.9	\$7.0	2.76%
2010	\$262.0	\$9.0	3.46%
2009	\$288.6	\$11.1	3.83%

The portfolio's yield for the fiscal year ending June 30, 2018 was 1.58 percent on an average portfolio of \$585.8 million, returning approximately \$9.3 million, which was used during the fiscal year to fund the services and programs provided by the City. This compares to the prior fiscal year ending June 30, 2017, in which the portfolio's yield was 1.27 percent on an average portfolio of \$454.6 million, returning approximately \$5.8 million. Over the past 10 years, the Interest Yield was as high as 3.83 percent with \$11.1 million in interest earned. During this same time period, the size of the average portfolio has increased, more than doubled, from \$288.6 million to \$585.8 million.

Portfolio Value, Composition, and Diversification

As of June 30, 2018, the City's portfolio was composed of investments in the following types of securities, shown here with comparison to the Policy limit (dollars in millions):

	<u>Market Value</u>	<u>Cost Value</u>	<u>Cost Value as Percent of Total</u>	<u>Policy Limit</u>
Treasuries	\$ <u>253.9</u>	<u>257.0</u>	<u>40.3%</u>	Unlimited, Minimum 25.0%
Agencies				
FHLB	68.0	69.7	10.9%	25.0%
FHLMC	43.2	43.5	6.8%	25.0%
FNMA	<u>54.5</u>	<u>55.5</u>	<u>8.7%</u>	25.0%
Total – Agencies	<u>165.7</u>	<u>168.7</u>	<u>26.4%</u>	50.0%
LAIF*	<u>100.8</u>	<u>100.8</u>	<u>15.8%</u>	20.0%
Corporate Notes				
Apple, Inc.	6.9	6.9	1.1%	5.0%
Berkshire Hathaway	7.0	7.1	1.1%	5.0%
Chevron Corp.	7.9	7.9	1.2%	5.0%
Colgate-Palmolive	5.4	5.5	0.9%	5.0%
Exxon Mobil	5.9	6.0	0.9%	5.0%
Microsoft	5.8	6.0	0.9%	5.0%
Toyota Motor Corp.	5.4	5.6	0.9%	5.0%
US Bank	4.9	5.0	0.8%	5.0%
Walmart	<u>4.9</u>	<u>4.9</u>	<u>0.8%</u>	5.0%
Total – Corporates	<u>54.1</u>	<u>54.9</u>	<u>8.6%</u>	15.0%
Supranationals				
IBRD	17.7	18.1	2.8%	5.0%
IFC	11.2	11.4	1.8%	5.0%
IADB	<u>17.5</u>	<u>17.8</u>	<u>2.8%</u>	5.0%
Total – Supranationals	<u>46.4</u>	<u>47.3</u>	<u>7.4%</u>	10.0%
Municipal Bonds**	8.3	7.7	1.2%	
U. S. Bank Balance	0.1	0.1	0.0%	
Accrued Interest	<u>2.8</u>	<u>-0-</u>	<u>0.0%</u>	
Total Holdings	632.1	636.5		
City Bank Balance	<u>-0-</u>	<u>2.0</u>	<u>0.3%</u>	
Total Portfolio	<u>\$632.1</u>	<u>638.5</u>	<u>100.0%</u>	

* Local Agency Investment Fund managed by the State Treasurer.

** Municipal bonds issued by the City, or a component unit, are permitted investments when approved by Council.

The total portfolio increased to \$638.5 million (cost value), \$632.1 million market value, compared to \$535.0 million and \$432.7 million (cost value) at the end of Fiscal Years 2016-17 and 2015-16, respectively. Fiscal Year 2016-17 was the first time the City's portfolio has reached over \$500 million, and the portfolio is now over \$600 million.

The investment in Corporate Notes began in July 2013 and is being managed by the external investment advisor, Chandler Asset Management. As of June 30, 2018, the portfolio held \$54.9 million (cost value) in Corporate Notes. The benchmark index used for Corporate Notes is the Merrill Lynch one- to five-year AAA-AA US Corporate Index. This benchmark is a higher standard as it includes investments that are not permitted under the City's Policy (e.g., corporations outside of the U.S.). As of June 30, 2018, the Corporate Note segment of the portfolio TRR was 0.32 percent compared to the benchmark of 0.07 percent. Corporate Notes are approximately 8.6 percent of the portfolio (up to 15.0 percent is allowed per the Policy).

Three years ago, the Committee recommended, and the City Council approved, adding the Supranational security asset class as a permitted investment with certain limitations. As of June 30, 2018, the portfolio held \$47.3 million (cost value) in Supranational securities or about 7.4 percent of the portfolio (up to 10 percent is allowed per the Policy).

The portfolio investments above represent the cash assets of the various funds and reserves of the City. Most of the City's portfolio is budgeted or obligated for specific purposes such as capital improvement projects, operating budgets, liabilities, and commitments and reserves. Unobligated balances in each fund were presented to Council during the Fiscal Year 2018-19 budget process and are included in the Fiscal Year 2018-19 Adopted Budget. Fund ownership of portfolio assets are as follows (cost value and dollars in millions):

General Fund, Including Reserves	\$139.9	21.9%
Restricted Funds (Utility and Special-Purpose Funds)	200.4	31.4%
Debt Service Funds	0.1	0.0%
Capital Projects	221.7	34.7%
Internal Service (Insurance Reserves and Internal Operations)	45.9	7.2%
Trust and Agency Funds	<u>30.5</u>	<u>4.8%</u>
Total Portfolio	<u>\$638.5</u>	<u>100.0%</u>

The City began depositing funds into the California Employer's Retirement Benefit Trust (CERBT) Fund in February 2009 for the City's obligation of retirees' health benefits. The CERBT offers three investment strategy options, Strategy 1 being the least conservative with the highest estimated return and Strategy 3 being the most

conservative with the lowest estimated return. Agencies are allowed to choose which strategy option to place funds. The City currently participates in Strategy 2 as approved by the Committee and Council, in order to preserve the balance in the trust. The retirees' health valuation is updated every two years as required by Generally Accepted Accounting Principles (GAAP). The valuation was most recently updated as of July 1, 2017 using the discount rate for Strategy 2 of 6.73 percent (at the time the valuation was complete). The valuation also provided information using both a 6.5 percent and 6.25 percent discount rate. For Fiscal Year 2018-19, the 6.5 percent discount rate is used in order to provide a margin for adverse deviation with a projected liability of \$151.3 million as of July 1, 2018. The balance in the trust as of June 30, 2018 is \$125.2 million (including interest earned, net of administrative expenses), or is 82.8 percent funded.

In addition, as anticipated, the CERBT has reduced its expected long-term annualized rate of Investment return from 7.28 percent to 7.01 percent, a reduction of 27 basis points. As a result of this action by CERBT, the City's discount rate was recommended to be reduced to 6.25 percent for Fiscal Year 2019-20. Staff presented this information to the Council Finance Committee (CFC) on March 27, 2018 and the CFC approved the recommendation. This was approved by the City Council with the Fiscal Year 2018-19 Adopted Budget.

Internal Control and Reporting

A significant process of internal control, oversight, and reporting is set out in the Policy. Additional controls and reporting beyond Policy requirements are also employed. All Policy-required controls, reports, and meetings have been complied with during the fiscal year. The control and oversight process encompasses the activities outlined below:

- Monthly internal investment status and strategy meetings between the Finance and Administrative Services Director and the Assistant Finance and Administrative Services Director/Investment Officer.
- Monthly portfolio reports submitted by the Finance and Administrative Services Director and the external investment advisor to the City Council, the IRC, and others.
- Quarterly meetings between the Finance and Administrative Services Director and the external investment advisor, with the City Manager, or designee, attending semiannually (as required by Policy), to review economic indicators, portfolio status, and Policy compliance with related reports distributed to the City Council and the Committee.

- Annual meeting of the Committee to review and discuss portfolio status and management, the Policy, and Policy compliance.
- Submission of an annual report to the City Council from the Committee and Finance and Administrative Services Director containing the findings and recommendations of the Committee.

In addition, the City's external auditors annually review internal controls on portfolio transactions, including segregation of duties between staff, controls on access to funds, and compliance with State laws regarding public agency investing as part of their annual audit of the City's financial statements. No finding of a material weakness in internal control is noted.

Section 6 of the Policy addresses Social Responsibility as an objective of the Policy and pertains to investments in banker's acceptances, medium-term corporate notes, and certificates of deposit. The policy encourages applicable investments to be made in entities that support social and environmental concerns and community investment. Investments in companies that manufacture cigarettes and firearms as identified by the Investors Responsibility Research Center are prohibited. As of June 30, 2018, the City was in compliance with the socially responsible investing provisions of the Policy.

Staff attempts to "ladder" the portfolio by allocating investments so that a relatively equal portion of the portfolio matures in each fiscal year of the five-year maximum investment maturity permitted by Policy. This is done to manage cash flow and to minimize the risk of interest rate movements over time. In a period of declining interest rates, this approach results in the average portfolio yield and market value exceeding current market rates due to holdings of prior year investments yielding above-market interest rates. In periods of rising interest rates, however, the opposite occurs. Securities purchased in prior years with interest rates below current market rates results in market value losses compared to the cost of securities. Gains and losses are considered as "paper" impacts because the City generally does not sell securities before they mature and receives the full value of invested principal at maturity. However, at fiscal year-end, GAAP requires gains or losses in portfolio market value to be recorded as revenues or expenditures.

The 2017-18 fiscal year-end market value (plus accrued interest) of the portfolio was lower than the cost value by approximately 0.69 percent or \$4.4 million. In comparison, the 2016-17 fiscal year-end market value (plus accrued interest) of the portfolio was higher than the cost value by approximately 0.48 percent or \$2.5 million. GAAP requires fiscal year-end portfolio gains to be treated as revenue and fiscal year-end portfolio losses to be expensed. Gains or losses are allocated to each fund based on each

fund's share of the portfolio balance, the same manner that interest is credited. Gain entries increase fund balances reported in the fiscal year-end financial statements and loss entries reduce reported fund balances. Neither have an effect on the balances available for budgetary purposes.

Findings and Observations

There were no findings. The portfolio was in compliance throughout Fiscal Year 2017-18.

Committee Discussion

At the October 31, 2018 meeting, the Committee discussed the following aspects of the portfolio:

- The Committee discussed environmental, social, and governance (ESG) ratings. Staff provided their assessment of the lack of an effective rating system and provided options to incorporate into the City's Policy. The Committee requested additional information, a more in-depth analysis of what is included in other agencies' investment policies, and information on and ESG rating that would identify socially responsible energy companies. The City's external investment advisor, Chandler Asset Management, advised the Committee there are a limited number of corporations that comply with the City's stricter AA rating for Corporate Notes and prohibiting Chevron and Exxon Mobil or other energy companies will further reduce eligible Corporate Notes. In addition, the Committee approved recommending to the City Council that the City divest its holdings in Chevron and Exxon Mobil immediately and directed staff not to purchase Chevron or Exxon Mobil until the matter is decided.
- The Committee discussed segregating a portion of the portfolio, not needed for cash-flow purposes, to be invested in longer-term maturities pursuant to California Government Code Section 53601. Staff identified \$60.0 million, or about 10 percent of the portfolio, consisting of a variety of reserves. Although staff did not recommend investing in long-term maturities at this time due to the relatively flat yield curve, staff did recommend updating the Policy to allow the purchase of up to 10 percent of the portfolio be invested in maturities of up to 10 years. The Committee took no action on this item.
- The Committee discussed additional recommendations made by staff to clean up a few areas in the Policy. These included changing "Supra National" to "Supranational," correcting the minimum rating for Supranational Securities from "AA-/Aa-" to AA/Aa," and having the rating for Supranational Securities be from

one of the three rating agencies instead of two of the three rating agencies. The Committee approved recommending these changes to the Policy to the City Council.

At the November 26, 2018 meeting, the Committee discussed the following aspects of the portfolio:

- The Committee discussed other agencies' investment policies and if they included ESG ratings. In particular, staff provided information on Santa Clara Valley Water District's and the City of Palo Alto's investment policies. The City's external investment advisor, Chandler Asset Management, provided more information on ESG ratings and services, and the Committee discussed further. Staff recommended adding two subsections to the Policy and provided an alternative. The Committee approved recommending the two subsections, with edits, to the City Council.

RECOMMENDATIONS

Recommendations from October 31, 2018:

- The Committee approved recommending to the City Council the City divest all holdings in Chevron and Exxon Mobil and directed staff not to purchase Chevron or Exxon until the matter is decided.
- The Committee approved staff's recommendations to update the areas of the Policy related to the Supranational Securities for clean-up and correction.

Recommendations from November 26, 2018:

- The Committee approved staff's recommendations, with edits, to add Sections 6.1.3 and 6.3.3 to the Policy related to environmental social responsibility as follows:
 - 6.1.3 Investments are encouraged in entities involved in the production of renewable energy and sustainable agriculture, and that demonstrate a commitment to environmental sustainability, and the transparency and accountability in corporate governance.
 - 6.3.3 No investment is to be made in entities that engage in the direct exploration, production, refining or marketing of fossil fuels.

CONCLUSION

The Councilmembers of the Committee would like to acknowledge and thank Committee member Steven Permut for his 13 years of service and Janice Phan for her 2 years of service, and for their participation, advice, perspective, and contributions.

The Committee concludes the City's portfolio has been competently administered with no Policy violations over the past fiscal year.

KSR-PJK/SN/2/FIN

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